



U.S. Department of Justice

Antitrust Division

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VIA FACSIMILE

Lori R. Larson, Esq.
 Chief, Public Contracts & Technology Branch, General Legal Services
 Internal Revenue Service, Department of the Treasury
 950 L'Enfant Plaza, S.W. 2d Floor
 Washington, D.C. 20026

Re: IRS Free File Program

Dear Ms. Larson:

Thank you for your letter of March 18 requesting advice regarding the Internal Revenue Service's ("IRS") Free File program. As you explained in your letter, this highly successful program is nearing the conclusion of its third full tax-filing season, and the IRS is preparing to enter renewal negotiations with the Free File Alliance, LLC ("the Alliance"). In preparation for those discussions, you have asked the Antitrust Division to provide legal advice regarding the recent expansion in the scope of free services offered through the program. While the original agreement between the IRS and the Alliance envisioned that at least sixty percent of individual taxpayers would be eligible to receive services through the program, this year ten out of twenty Alliance members offered their services without restriction to one-hundred percent of individual taxpayers. In connection with this expansion, you have asked us to respond to two questions:

- (1) Given the agreements in place, is the provision of free services to all taxpayers either anti-competitive or a violation of the antitrust laws?
- (2) Can the Treasury Department/IRS, Free File Alliance, or any other interested stakeholders place limitations on the scope of offerings related to the Free File program?

Before I respond to your specific questions, I would like to describe my understanding of how the Free File program works and the recent expansion in program coverage. If my understanding is incorrect in any material way, please advise me at your earliest convenience.

Background. The IRS's Free File Program is a public/private partnership between the IRS and the Alliance (which is a consortium of tax-software firms) designed to provide no-cost electronic tax-preparation and filing services to American taxpayers. The basic concept of the Free File program is that Alliance participants offer free services to the public through a web page hosted by

the IRS at www.irs.gov. This arrangement satisfies Congressional indications that the IRS should not supplant the private electronic tax-preparation industry but rather should work with the private sector to make such services available to taxpayers. See, e.g., *H.R. Report 107-575*, at 38 (2002).

The Alliance categorizes its members into five "tiers" according to the percentage of taxpayers to whom each member is willing and able to provide free services. For instance, the highest tier – Tier 1 – is reserved for those firms that offer free services to over fifty percent of taxpayers.¹ By providing certain benefits to the higher tiers, the tier structure encourages Alliance participants to expand their free offerings and thus collectively to achieve the IRS's goal of providing free services to at least sixty percent of the taxpaying public.

Specifically, higher-tier members receive two forms of marketing priority. First, higher-tier members are listed first on the Free File website. Second, when a taxpayer uses the website's vendor selection "wizard" to identify firms that will provide him or her free services, the wizard identifies higher-tier members first. Accordingly, a Tier 1 member always appears above a Tier 2 member either on the main list page or via the selection wizard. Within tiers, however, there is no advantage given to those firms that provide free services to a greater percentage of the public. Instead, the website and wizard both list Alliance members within each tier randomly. For instance, a Tier 1 member serving fifty percent of the public could (and often does) appear above a Tier 1 member offering free services to all taxpayers.

Aside from their commitment to offer free services, Alliance participants are subject to several other requirements and prohibitions. First, participants must satisfy a series of privacy, confidentiality, technical-proficiency, and other performance standards delineated in the Alliance's operating agreement and in its agreement with the IRS. Second, Alliance participants are prohibited from conditioning free services on the purchase of paid goods or services. Third, participants are prohibited from sharing information with each other regarding the nature and scope of their free services before they actually make those services available to the public through the Free File website.

In its first year of operation (the 2003 filing season), the Free File Alliance had seventeen members, including the two largest providers of tax software, Intuit, Inc. (TurboTax) and H&R Block (TaxCut). During the 2003 filing season most Alliance participants only offered free services to taxpayers who had less than a certain Adjusted Gross Income ("AGI"). Those AGI limits ranged from \$9,200 to \$33,000.² Given those parameters, however, 119 million out of 127 million individual taxpayers (or approximately 94 percent) were eligible to receive Free File Services. Approximately 2.8 million taxpayers actually took advantage of the program.

¹Tier 5 is reserved for new entrants into the tax-software industry who cannot rely on past performance to demonstrate their ability to satisfy the Alliance's technical requirements. Instead, Tier 5 participants self certify that they can meet those requirements. Tier 5 is designed to ensure that Alliance membership does not become a barrier to entering the tax-software industry.

²One participant had an AGI limit of \$100,000 but only served taxpayers filing Form 1040E2.

The 2005 filing season has witnessed a marked increase in the availability of no-cost services through the Free File program. Ten out of the twenty participants in the 2005 Free File program (including market leaders Intuit and Block) offered Free File services to all taxpayers without restriction.³ Accordingly, this year all individual U.S. taxpayers filing a return between January 1 and April 15, 2005, had the option of receiving free filing services through the Free File program. As of March 25, 3.74 million taxpayers had filed their returns through Free File, a 43.7 percent increase over the same time last year.

Attitudes among Alliance participants regarding this expansion are divided. Several Alliance participants have enthusiastically embraced unrestricted free service because they have found the Free File program to be an effective method of cross-selling their paid goods and services (e.g., state filing services, tax advice, financial products and services, etc.). Other Alliance members are opposed to unrestricted free offerings. Those opposed to the expansion of free services claim that the IRS, through the Free File program, has become a *de facto* universal provider of free electronic tax-preparation services. Moreover, they claim that the Free File program's tier structure is in part responsible for the expansion of the program's coverage. They are now lobbying Treasury and/or the IRS to limit the scope of free services available through the program. Alliance members in this camp claim that, without Treasury/IRS intervention, the unchecked expansion of the Free File program will reduce investment, innovation and competition in the market for tax-preparation software.

With that understanding, I now turn to your specific questions.

(1) *Given the agreements in place, is the provision of free services to all taxpayers either anti-competitive or a violation of the antitrust laws?*

The growing availability of unrestricted free services through the Free File program appears simply to be the result of competition among members of the Free File Alliance. As long as Alliance members are independently expanding their free offerings, such expansion and the competition driving it are precisely the sort of activities the antitrust laws were designed to protect. Several Alliance members indicate that they willingly provide free federal filing services because doing so increases their sales of full-price tax-preparation and financial-advisory services. Such "loss leader" strategies generally do not raise competitive concerns. See *Stitt Spark Plug Co. v. Champton Spark Plug Co.*, 840 F.2d 1253, 1256 (5th Cir. 1988); *Janich Bros., Inc. v. American Distilling Co.*, 570 F.2d 848, 856 (9th Cir. 1977); *Bayou Bottling, Inc. v. Dr. Pepper Co., et al.*, 543 F. Supp. 1255, 1268 (W.D. La. 1982).

Nothing I have reviewed suggests that Alliance members are cooperating with each other in this expansion. Similarly, nothing I have reviewed suggests that Alliance members are using the program to signal their competitive intentions to each other either in connection with free services or ancillary paid services. If in fact Alliance members were coordinating their competitive efforts or using the program to facilitate such coordination, this could raise competitive concerns that the Antitrust Division might want to look at more closely.

While loss-leader strategies bear a superficial resemblance to predatory pricing, the two can be easily distinguished. A firm engaged in predatory pricing succeeds by pricing below cost in the hope of driving out competitors and later recouping its short-term losses by charging a monopoly price. In contrast, a loss-leader strategy does not depend on the elimination of competition and is instead immediately profitable in the short term. Phillip E. Areeda, Herbert Hovenkamp, *Antitrust Law*, § 742F, Vol. III, at 470-71 (2d ed. 2002). Consistent with that, it appears those Free File Alliance members that offer unrestricted free services believe that doing so profitably increases their sales of full-price products and services. To our knowledge, no one has suggested that the offering of unrestricted free services through the Free File program has driven anyone from the tax-software segment or prevented anyone from entering it. Accordingly, the recent expansion of free services through the Free File program appears simply to be a form of pro-competitive price cutting.

It is also worth noting that Free File's tier structure does not appear to be causing the expansion in unrestricted free services. It is true – up to a point – that the tier structure encourages Alliance participants to expand the scope of their free offerings. The higher a firm's tier, the more prominent is its placement on the website and via the wizard. Under the tier structure, however, the benefits of a firm expanding its free offerings are exhausted once the firm offers free services to fifty percent of the tax-paying public (i.e., the threshold necessary to achieve Tier 1 membership). The website and the wizard treat all Tier 1 participants equally. That is, the website is just as likely to list a Tier 1 participant first whether that participant offers free services to fifty percent of taxpayers or one-hundred percent. Accordingly, once an Alliance member offers free services to fifty percent of taxpayers, it derives no further benefit from the Free File website by expanding the availability of its free services.

Moreover, it seems unlikely that unrestricted free services will suppress innovation in the tax-preparation software sector. Some have contended that by giving away federal tax-preparation services, Alliance members lose all incentive to invest in research and development. This view ignores the full competitive utility of the Free File program. While it is true that the free federal products themselves do not generate revenue, they are still useful as a tool for marketing other services. Accordingly, Alliance members still have incentives to improve their Free File products because doing so makes those free products a more effective tool for cross-marketing full-price goods and services.

(2) Can the Treasury Department/IRS, Free File Alliance, or any other interested stakeholders place limitations on the scope of offerings related to the Free File program?

This is really two questions, the answers to which turn on who is imposing the limitations – i.e., the government or members of the tax-software industry. Consistent with our previous advice (see my letter to Linda R. Horowitz, dated April 5, 2004), both Treasury and/or the IRS are free to impose limitations on the scope of the Free File program without risk of antitrust liability. The Supreme Court has made clear that neither the United States nor any agency “of the executive branch of the Government of the United States” is a “person” subject to potential liability under the Sherman Act. *United States Postal Service v. Flamingo Indus., Ltd.*, 234 S. Ct. 1321, 1328 (2004).

That said, we would still encourage you to allow members of the tax-software industry to independently price their products as they see fit. The trend towards unrestricted Free File offerings

appears to be a function of competition among Alliance members and should be encouraged. Of course, we recognize that the IRS must balance competing policy goals and is responsible for the long-term viability of the Free File program. In light of that, your agency is uniquely well-positioned to assess whether the expansion of free services threatens the viability of the Free File Alliance and the Free File program. In making your assessment, we encourage you to take into account the value that unrestricted free tax-preparation services represent to the American public.

Collective action by the Free File Alliance or its members is a different question. The expansion of free services through the Free File program is in essence a form of price cutting. Accordingly, any agreement among Alliance members to restrict such free service is likely a form of price fixing (or at least price stabilization). As such, the Antitrust Division would take seriously any coordinated attempt by Alliance members, other tax-software firms or third parties acting on their behalf, to restrict free services available through the Free File program. Similarly, the Antitrust Division would be concerned by any attempts by Alliance members to use the Free File program as a mechanism to coordinate the terms on which members offer goods or services (either free or paid). Should the IRS become aware of attempts in either regard, we would appreciate your notifying us immediately."

I hope the preceding has been helpful. If you have any questions, please do not hesitate to call me at 202-616-0944 or Garrett Duarte at 202-353-1926.

Sincerely,


Renata B. Hesse
Chief, Networks & Technology Section

cc: Thomas O. Barnett, Esq.
David K. Barnes, Esq. (CC:GLS:PCTL-2ND:DBarnes)

"While any agreement among Alliance members to restrain the availability of Free File services would be of great interest to the Antitrust Division, Alliance members generally have the right jointly to petition the government to adopt restrictive measures without violating the antitrust laws. See *Eastern Railroad Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127 (1961); *United Mine Workers of America v. Pennington*, 381 U.S. 657 (1965).